United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-4030

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

INTERNATIONAL FLAVORS & FRAGRANCES INC.,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
MICHAEL L. PAUP,
ROBERT A. BERNSTEIN,
Attorneys,
Tax Division
Department of Justice,
Washington, D.C. 20530.

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STATEMENT OF THE ISSUE PRESENTED

Whether taxpayer's purported transfer of a contract providing for the forward sale of British pounds constituted a sale in substance as well as in form, or whether the putative purchaser should be viewed as having acted on taxpayer's behalf when it, on the same day as it allegedly "purchased" the forward sale contract, purchased pounds to close out the contract.

STATEMENT OF THE CASE

This appeal involves federal income taxes for the taxable year 1967 in the amount of $73,715. The decision of the Tax Court (Judge William H. Quealey) was entered on October 15,

1974. (R. 120.) 1/ Notice of appeal was timely filed by taxpayer on January 3, 1975. (R. 122.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts, as stipulated (R. 3-8) and as found by the Tax Court (R. 84-119), may be summarized as follows:

Taxpayer manufactures flavor and fragrance products for use in a variety of consumer products. It carries on its activities worldwide through a number of foreign affiliates which it owns either directly or indirectly. One of these foreign corporation is International Flavors & Fragrances I.F.F. (Great Britain) Ltd. (IFF-GB). IFF-GB is taxpayer's wholly owned, second tier subsidiary. All of its stock is owned by International Flavors & Fragrances IFF (Nederland) N.V. (IFF -- Holland), a corporation which, in turn, is taxpayer's wholly owned subsidiary. IFF-GB has manufacturing, research, and administrative facilities in Haverhill, England. (R. 3,4.)

Taxpayer does not file consolidated returns with its affiliates for income tax purposes. However, it does prepare consolidated financial statements for distribution to its shareholders and to the public. For the purposes of these

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1/ "R." references are to the separately bound record appendix.

statements, accounts of the foreign affiliates are converted into United States dollars. During 1966, taxpayer became concerned about a possible devaluation of the British pound sterling and the adverse effect this would have on the accounts of IFF-GB as reflected on the annual consolidated financial statement. Accordingly, taxpayer's officers decided to enter into a forward sale contract of British pounds, in an amount sufficient to offset the potential devaluation, in terms of dollars, of the exposed assets of the British affiliate. (R. 87, 88.)

On December 29, 1966, taxpayer entered into a written contract with First National City Bank of New York (FNCB) pursuant to which taxpayer sold to FNCB 1.1 million British pounds sterling at $2.7691 per pound, delivery and payment to be made on January 3, 1968. The contract contained certain security provisions requiring taxpayer to deposit certain funds with FNCB upon the latter's request if the market value of pounds should rise above the contract price. In fact, taxpayer maintained substantial deposits with FNCB during the contract period. (R. 88-89.)

On November 18, 1967, the British government devalued the pound sterling in terms of the U.S. dollar from $2.80 to $2.40. (R. 90.)

On December 20, 1967, taxpayer entered into an agreement with Amsterdam Overseas Corporation (Amsterdam), a large inter-

national banking institution located in New York City. The agreement, which was in letter form from taxpayer to Amsterdam and accepted by Amsterdam, read in pertinent part as follows (R. 90):

> Enclosed is the original of our agreement of December 29, 1966 with First National City Bank which we hereby sell to you today for $387,000. This sale is on the understanding that you will fulfill the obligation to deliver Sterling 1.1 million to First National City Bank on January 3, 1968 without recourse to us.

On the same day as this agreement was entered into, the following events also transpired (R. 90-91):

(1) Taxpayer notified FNCB that it had sold its contract with FNCB to Amsterdam.

(2) Amsterdam notified FNCB that it had bought the contract. It agreed to assume liability thereunder if FNCB would confirm its intent to pay the sum of $3,046,010 upon the delivery of 1.1 million pounds sterling on January 3, 1968.

(3) At 4:18 p.m., Amsterdam received notification from FNCB of its approval of Amsterdam's purchase of the contract. FNCB also confirmed that on January 3, 1968,

it would credit the dollar account of Amsterdam with the difference between its own obligation under the contract, $3,046,010, and the dollar cost to Amsterdam of purchasing from FNCB, at the prevailing rate of exchange, the 1.1 million pounds sterling needed to close out the contract on such date.

(4) At 4:30 p.m., Amsterdam purchased 1.1 million pounds sterling at the rate of $2.4080 from FNCB for delivery on January 3, 1968.

On December 21, 1967, Amsterdam sent a check to taxpayer in the amount of $387,000 representing the price agreed upon for the purchase of the contract. On January 3, 1968, Amsterdam closed out the contract with the 1.1 million pounds sterling purchased short from FNCB on December 20, 1967. The net gain to Amsterdam on the transaction was $10,210. (R. 91-92.)

On its return for the taxable year 1967, taxpayer reported the $387,000 gain realized from the sale of its contract as long-term capital gain. The Commissioner asserted deficiencies for that year on the basis that taxpayer had not in fact sold the forward sale contract to Amsterdam, and that its gain should have been reported as short-term capital gain. In the alternative, the Commissioner asserted that, if it was a bona fide sale, the transfer of the contract was a

hedging transaction and the gain should have been taxable as ordinary income.

In an opinion reviewed by the entire Tax Court, Judge Quealey for the majority agreed with the contention that the transfer of the contract was a hedging transaction subject to the doctrine announced in Corn Products Co. v. Commissioner, 350 U.S. 46 (1955), and that it therefore resulted in ordinary income. In dicta, the majority opinion observed, however, that the transfer did not appear to have constituted a sale, but rather that Amsterdam's role appeared to be more nearly that of a broker than a purchaser. (R. 97-105.)

In a concurring opinion on behalf of himself and two other judges, Judge Tannenwald found that Amsterdam was in reality acting on behalf of taxpayer in contracting to purchase pounds from FNCB. He concluded, therefore, that taxpayer's profit should be treated as short-term capital gain. (R. 106-115.)

In a dissenting opinion on behalf of herself and two other judges, Judge Hall disagreed with both the majority and concurring opinions. She rejected the applicability of the Corn Products doctrine, and, on the facts, would have found that taxpayer had sold its forward sale contract to Amsterdam, a transaction which she would have held qualified for long-term capital gain taxation. (R. 116-119.)

Decision was entered against the taxpayer, and taxpayer appeals from that decision. (R. 120, 122.)

SUMMARY OF ARGUMENT

In late 1966, taxpayer entered into a forward sale contract with FNCB under which taxpayer agreed to sell 1.1 million British pounds on January 3, 1968, at $2.77 per pound. The pound was devalued in November of 1967. On December 20, 1967, taxpayer purported to sell its forward sale contract to Amsterdam. On the same date, Amsterdam entered into a forward purchase contract with FNCB, under which Amsterdam agreed to buy 1.1 million pounds on January 3, 1968. Taxpayer contends it is entitled to long term capital gain treatment of its profit from these transactions, on the ground that it sold its contract to Amsterdam and that the contract was a capital asset held by taxpayer for more than six months.

On appeal, the Commissioner urges this Court to adopt the finding of the concurring opinion below, which was expressly approved also, though in dictum, by the majority opinion. Specifically, the finding -- amply supported by the evidence -- is that taxpayer did not sell its contract to Amsterdam, but, rather, that Amsterdam in dealing with FNCB was merely acting on behalf of taxpayer. So viewed, the transactions properly resulted in short term capital gain to taxpayer.

Taxpayer had the burden of disproving the Commissioner's assertion, set forth in the notice of deficiency and at trial below, that the transfer from taxpayer to Amsterdam was not a bona fide sale. It undertook to meet this burden through the testimony of a company official who was not employed by taxpayer until more than two years after the December, 1967, transactions. His only testimony relevant to this factual issue was ambiguous and negative in form -- namely, that he had been unable to find in taxpayer's files any copies of the contract between Amsterdam and FNCB. Significantly, taxpayer did not call as witnesses any company officials who were with the company in December of 1967 and who did participate in the negotiations with Amsterdam.

The manner and form of the December 20, 1967, transactions combines with taxpayer's failure to call other witnesses to compel the conclusion that taxpayer was a party to the forward purchase contract entered into, in form only, by Amsterdam. Accordingly, the finding of the concurrence is clearly correct.

ARGUMENT

TAXPAYER'S PROFIT SHOULD BE TREATED AS SHORT-TERM CAPITAL GAIN BECAUSE THE EVIDENCE SUPPORTS THE FINDING, APPROVED BY BOTH THE MAJORITY AND CONCURRING OPINIONS BELOW, THAT AMSTERDAM CONTRACTED TO PURCHASE POUNDS ON TAXPAYER'S BEHALF

A. Nature of the case.

Taxpayer operates a world-wide business operation, in part through multi-tier foreign subsidiaries. During 1966,

it became concerned about the possible devaluation of the British pound, because of the adverse effect devaluation would have on its consolidated financial statement (via a reduced dollar value of the assets of its British subsidiary). As a hedge against this eventuality, taxpayer on December 29, 1966, entered into a forward sale of British pounds with First National City Bank of New York (FNCB). The contract obligated taxpayer to sell FNCB 1.1 million pounds sterling at $2.7691 per pound, with delivery and payment to be made on January 3, 1968.

On November 18, 1967, the pound was devalued from $2.80 to $2.40. On that day, therefore, taxpayer's rights under the forward sale contract acquired a substantial value (nearly $400,000) which taxpayer could realize, in any one of a variety of manners, at any time up to the contract delivery date of January 3, 1968.

One method would have been simply to hold the contract to maturity, buying pounds on or before January 3, 1968, for delivery to FNCB at that time. The profit taxpayer would realize under these circumstances would be taxable as short-term capital gain. The holding period of the pounds bought and sold would necessarily be less

than six months, since the pounds would have to be purchased after November 18, 1967 (date of devaluation) and sold on January 3, 1968 (date of delivery). 2/ The amount of the gain would of course be subject to increase or decrease due to fluctuation of the exchange rate in the interim between devaluation and the date it acted to purchase pounds. 3/

An alternative means of effecting performance of its contract would be for taxpayer to engage in so-called contractual setoff. That is, it could have entered into a forward purchase contract at any pertinent time under which it would promise to buy 1.1 million pounds on January 3, 1968. This would have the effect of fixing taxpayer's profit on the date it entered into the forward purchase contract, in an amount equal to the difference between its proceeds under the forward sale contract and its cost under the forward

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2 / Both the Commissioner and the courts which have considered the question have held that foreign currency is "property," within the meaning of Section 1221 of the Internal Revenue Code of 1954 (26 U.S.C.), the sale or exchange of which is capable of giving rise to capital gain or loss. Gillin v. United States, 423 F. 2d 309, 312 (Ct. Cl., 1970); KVP Sutherland Paper Co. v. United States, 344 F. 2d 377, 379-80 (Ct. Cl., 1965); Rev. Rul. 74-7, 1974-1 Cum. Bull. 198.

3 / Wool Distributing Corp. v. Commissioner, 34 T.C. 323, 328, fn. 1 (1960), described the transaction as follows: "On the date of delivery, or before, the seller may 'cover' by buying the fixed amount of currency at the then current rate of exchange. The gain or loss to the seller is determined by comparing the rate at which he agreed to sell with the rate of exchange on the date of 'cover'." (Emphasis in original.)

purchase contract. Such a contractual setoff has been held to be the equivalent of delivery under the forward sales contract. Arnall v. United States, 4 A.F.T.R. 2d 5975 (N.D. Ga., Nov. 21, 1959).

A third method of realizing its profit would have been for taxpayer to enter an agreement with FNCB to cancel the contract, under which taxpayer would receive compensation for its lost profits. Since contractual cancellation is not a sale or exchange -- because the contractual rights simply come to end and vanish, rather than being transferred -- the consideration would not be treated as capital gain. Commissioner v. Starr Brothers, Inc., 204 F. 2d 673 (C.A. 2, 1953) (payment for termination of exclusive sales contract, and execution of a new nonexclusive contract, held ordinary income because of lack of sale or exchange).

Finally, taxpayer could have realized its profit by selling its forward sales contract. Taxpayer contends that this is what it did, and that it thereby became entitled to long term capital gain treatment of the profit. This result follows, taxpayer contends, because its contract is "property" within

the meaning of Section 1221 of the Internal Revenue Code of 1954, Appendix A, infra, and had been held by taxpayer for more than six months.[4]

The Tax Court majority held that taxpayer's gain was ordinary income, on the ground that the forward sale contract was a hedging transaction, integrally related to the taxpayer's normal business operations within the meaning of Corn Products Co. v. Commissioner, 350 U.S. 46 (1955). Accordingly, the majority did not formally pass on the question of whether taxpayer had actually sold its contract to Amsterdam, and Amsterdam had then acted independently in closing out the forward sale with FNCB, or whether the transactions involving taxpayer and Amsterdam represented something other than a complete transfer. However, the majority opinion did observe (R. 104-105) that "In view of the sequence of events * * * it is clear that Amsterdam did not intend to assume any risk" and that Amsterdam's role "appears to be more nearly that of a broker than a purchaser." The concurring opinion developed this view in more detail. It made a formal factual finding to the effect that "Amsterdam was in reality acting on behalf of * * * [taxpayer] in contracting to purchase pounds from the First National City Bank." (R. 106.)

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4 / Section 1222(3) of the Internal Revenue Code of 1954 (26 U.S.C.) provides that long-term capital gain means gain from the sale or exchange of a capital asset held for more than six months.

On appeal, the Commissioner does not urge upon this Court the so-called Corn Products doctrine relied on by the Tax Court majority. This is because, to our knowledge, that doctrine has not heretofore been applied in a case in which a hedging operation was entered into by one corporation as a protection against a potential inventory loss of another corporation, even where the second corporation is a subsidiary of the first.

However, we do adopt and urge the factual finding relied on by the concurrence and expressly approved by the majority. Specifically, we contend that taxpayer did not sell its contract to Amsterdam, but that Amsterdam instead acted on behalf of taxpayer when it bought pounds and sold them to FNCB, with the result that taxpayer realized a short-term capital gain.

B. The plan adopted by the parties did not contemplate that Amsterdam would acquire ownership of the forward sale contract, but provided only for the payment of a fee to Amsterdam for its participation as intermediary

As explained in Part A, supra, after the British pound was devalued on November 18, 1967, taxpayer was faced with a choice of various methods of realizing its profit on its forward sales contract. The normal methods available to it included (a) performance of the contract, pursuant to its terms, by delivery to FNCB on January 3, 1968, of pounds purchased by taxpayer on or before that date, (b) offsetting of the forward sales contract by execution of a forward

purchase contract for the same number of pounds; (c) cancellation of the contract, with payment to taxpayer by FNCB as compensation for lost profits; or (d) a sale of the forward sale contract.

Taxpayer contends that it adopted method (d) -- that it sold its contract to Amsterdam. In reality, however, the series of transactions in which it engaged failed to contain the most basic element of a sale. Amsterdam never acquired independent ownership of any significant property interest in the contract nor did it ever incur the attendant risk of loss or potential for gain which would have accompanied such ownership interests. In effect, method (b) was adopted, but with Amsterdam executing the forward purchase contract on behalf of taxpayer.

The documents introduced by taxpayer in the Tax Court reveal that the series of transactions was designed as a unitary plan, composed of interdependent steps no one of which was to be effected in the absence of the others. As pointed out by the Tax Court concurrence (R. 107-108), the contract to purchase pounds between Amsterdam and First National City Bank, the notifications by IFF and Amsterdam to FNCB of Amsterdam's "purchase" of the 1966 contract between IFF and FNCB, and the acknowledgement of FNCB to Amsterdam were all dated the same day, namely, December 20, 1967. Thus, the concurrence drew the inference (R. 109-110) that "the existence

of Amsterdam's contract to purchase pounds was a precondition of the purported acquisition of the short sale contract from IFF" and that "an immediate offset of the two obligations was intended with the crediting of the differential in price on January 3, 1968, the only act remaining to be performed."

In short, the purported buyer, Amsterdam, in effect promised to pay a certain sum to taxpayer in return for the promise of FNCB to pay a somewhat larger sum certain to Amsterdam. The difference between the two sums represented a fee to Amsterdam for lending its name to the series of transactions. [5/] The events that transpired would indicate that Amsterdam was not willing to incur the usual risks of holding property capable of appreciating or depreciating in value. They indicate, rather, that Amsterdam was willing to participate only if it could be compensated on the basis of a fixed fee, and if it could be assured that it would not have to be subject to the normal risks of market fluctuation. It slightly different terms, it apparently agreed to participate

5/ No doubt the fee Amsterdam charged also reflected an element of interest, since it advanced an amount to taxpayer on December 21, 1967, which was not to be replaced (by FNCB) until 13 days later.

only if the transaction could be fashioned in a manner that would eliminate the usual ingredients of a sale. 6 /

It is settled, of course, that whether a sale took place is determined by the substance and not by the form or by the parties' own labeling of a transaction. "A mask of legal formalism can not change what actually transpired." Hilton v. Commissioner, 13 T.C. 623, 630 (1949); Wiener v. Commissioner, 316 F. 2d 473 (C.A. 2, 1963) (purported sale of a note to a factoring company; transaction held one by which taxpayer, acting on behalf of himself and the debtor, accomplished payment of note to himself through the medium of the factor as a conduit); Concord Lumber Co. v. Commissioner, 18 T.C. 843 (1952) (transaction cast as exchange

6 / An offsetting of contractual obligations, such as occurred here when Amsterdam entered into the forward sales contract, is the equivalent of delivery under the terms of the forward sale contract. See, to this effect, Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 248 (1905). Presumably, therefore, a setoff ordinarily would have the same tax effect as performance. In this case, this would mean that taxpayer would be treated as entering into both a purchase and a sale of pounds on the contract delivery date, January 3, 1968. However, taxpayer structured the transaction in such a manner that it received its payment (in the form of the check from Amsterdam) at the time of offsetting rather than on the delivery date. Generally, an accrual basis taxpayer is not permitted to defer reporting of advance receipts attributable to a future period of activity. See American Automobile Assn. v. United States, 367 U.S. 687 (1961) (membership dues received one year but attributable to following years). In any event, taxpayer has never questioned the timing, but solely the validity in the first instance, of the assessment in this case.

of claim for preferred stock; held not an exchange, where the substance was a subordination agreement among the creditors of the debtor).

It follows that there is no sale where the transaction never contemplated the actual transfer of the subject property, and was not motivated by the genuine prospect of outright ownership of the property by the purported buyer. Kolkey v. Commissioner, 254 F. 2d 51 (C.A. 7, 1958). 7 / Here, Amsterdam merely lent -- sold -- the right to use its name as an intermediary party in taxpayer's closing out of the forward sale contract. Amsterdam acted promptly to ensure that none of the burdens or benefits of true ownership attached to its status as intermediary by effecting an anticipatory closing through the mechanism of a forward purchase contract.

This was quite plainly an agreement to pay Amsterdam a fee in return for its lending its name as putative buyer. Equally plainly, this was not a sale.

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7 / Kolkey involved a bootstrap "sale" of a business to a tax-exempt "buyer." In Commissioner v. Brown, 380 U.S. 563 (1965), the Supreme Court held that a similar bootstrap sale did constitute a sale for tax purposes even though the tax-exempt buyer did not incur any risk of financial loss in the transaction. There was no indication in Brown that the parties intended the purported buyer to be merely a go-between -- indeed, the success of the tax maneuver there depended upon the "buyer" acting as the owner of the transferred business and "laundering" the profits derived from business operations through its tax-exempt wash. The tax-exempt buyer also had a real economic stake in the profits acrued by the transferred business. The sale in Brown, therefore, can hardly be compared to the present transfer, where the purported buyer obviously was acting as a mere intermediary between taxpayer and FNCB and received no more than a fixed fee for that service.

C. <u>Taxpayer failed to show that Amsterdam acted independently in closing out the forward sale contract</u>

The conclusion as to Amsterdam's role as broker was accepted by all but three members of the Tax Court as the most reasonable inference to be drawn from the evidence. The inference is plainly correct and is supported by the record. Taxpayer, which had the burden of proof below, attempted to rebut it. Its evidence, however, was of little probative value; moreover, as will be shown, its failure to call certain witnesses had the legal effect of strengthening the inference.

Taxpayer contends (Br. 30) that it "met any reasonable burden of proof that should be placed upon it." This is so, it argues (Br. 30), because it proved it had entered into a contract with Amsterdam which by its own terms characterized the transaction as a sale. This, of course, begs the question. No one has ever doubted that the parties <u>called</u> their transaction a sale. The question is, labels aside, whether what they effected actually <u>was</u> a transfer of the forward sale contract.

In this latter regard, taxpayer argues (Br. 31) that it did present evidence that it did not participate in or know of the transaction between Amsterdam and FNCB. This evidence, taxpayer states (Br. 31), was in the form of testimony by James Morrison, taxpayer's comptroller, to the effect that he

had not found in taxpayer's files any copies of the contract between Amsterdam and FNCB. It is true that Mr. Morrison so testified and that the purpose of the testimony, according to the statement of taxpayer's counsel at trial (R. 62), was to establish "the independence of the two parties" (taxpayer and Amsterdam). We suggest that this testimony, coupled with the statement of counsel, is particularly revealing, not of the independence of the parties but of their inter-dependence. For this portion of the record reveals that (a) taxpayer at trial affirmatively sought to prove the absence of any inter-dependence between it and Amsterdam, but that (b) the best proof it could muster was testimony by a company officer (who had not even begun to work for taxpayer until more than two years after the events in question) that its files did not at the time of his search contain any contract between Amsterdam and FNCB. (R. 43,62.) If taxpayer truly wanted to prove the parties' independence, it presumably might easily have done so by testimony of officers who were with the company in December of 1967 and who participated in the negotiations with Amsterdam. If taxpayer's factual contentions were correct, those officers could testify to their own first-hand knowledge that taxpayer did not participate in or know of the transaction between Amsterdam and FNCB. Since taxpayer had the burden of proof, its failure

to call such witnesses permits the inference that their testimony would, instead, have been unfavorable to taxpayer. Pollack v. Commissioner, 47 T.C. 92 (1966), aff'd, 392 F. 2d 409 (C.A. 5, 1968); Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), aff'd, 162 F. 2d 513 (C.A. 10, 1947).

Taxpayer argues, however (Br. 31), that even assuming taxpayer participation in the Amsterdam-FNCB agreement, "it does not follow that its sale of the FNCB contract to Amsterdam was thereby turned into an agency arrangement." In support of that proposition, taxpayer cites (Br. 31) a passage from the dissenting opinion below. The dissent's objection to the "agency" theory, however, is based essentially on the notion that taxpayer "could properly claim unfair surprise if taxed with the concurring opinion's theory that it failed to disprove that Amsterdam acted as petitioner's agent." The dissent's "unfair surprise" contention, in turn, is based entirely on the fact that counsel for the Commissioner, in his opening statement, stated (Br. 31; R. 29) that "IFF transferred its agreement with First National City Bank to Amsterdam Overseas Corporation for $387,000." The dissent (Br. 31; R. 119) termed this statement an "admission" and described it as "quite inconsistent with any notion of IFF's

subsequent retention of ownership." This analysis by the dissent, with due respect, seriously distorts the record. The validity of the purported sale was in issue from the beginning of this case, and taxpayer was plainly so aware. This is apparent from the following:

1. The notice of deficiency (Appendix B, _infra_) -- which was the basis of taxpayer's petition below (Appendix B, _infra_) -- described the pertinent adjustment to income as follows:

> It is held that the purchase by the Amsterdam Overseas Corporation of your contract with the First National City Bank for the sale thereto of British pounds sterling _was not a bona fide transaction_. Therefore, the gain on _your transaction with the First National City Bank_ is a short term capital gain. In the alternative, it is held that the sale of the pounds sterling was a hedging transaction, the gain whereon is taxable as ordinary income. (Empahsis added.)

Thus, the notice of deficiency challenged the structure of the IFF-Amsterdam transaction as a sale; moreover, it expressly treated taxpayer's compensation as coming from FNCB and not from Amsterdam.

2. In his opening statement, a few moments before speaking the sentence quoted by the dissenting opinion, counsel for the Commissioner phrased the issue before the court (R. 28-29) as whether the transfer of the forward sale contract "is a long-term capital gain in the amount of

$387,000 as reported by IFF or a short-term capital gain on the short sale of the pounds themselves as contended by Respondent." (Emphasis added.) In light of the statement in the statutory notice challenging the genuineness of the sale, plus the oral declaration by counsel that taxpayer was the seller of the pounds, counsel's later statement that taxpayer "transferred its agreement" plainly was a casual reference to the form rather than the substance of the transaction.

3. In the statutory notice and at trial, the Commissioner advanced an alternative argument to the effect that taxpayer had engaged in a hedging transaction. For purposes of that argument, the Commissioner accepted taxpayer's characterization of its transaction with Amsterdam as a sale. Accordingly, counsel's statement that taxpayer "transferred its agreement" to Amsterdam, even if interpreted literally, is not inconsistent with the fact that the Commissioner was arguing in the alternative that there was no transfer.

4. Taxpayer's counsel demonstrated at trial that he was in fact fully aware all along of the Commissioner's position that no sale to Amsterdam took place. Mr. Morrison's testimony, regarding the absence in taxpayer's files of any copies of the Amsterdam-FNCB agreement, was interrupted by questions from the court concerning the deficiency notice. (R. 54-62.) In the course of the ensuing colloquy, counsel for the Com-

missioner restated the Government's alternative position that there was "an agency relationship" between taxpayer and Amsterdam. (R. 59.) The court pronounced itself satisfied that the notice of deficiency properly raised the agency issue. (R. 61-62.) Counsel for taxpayer then explained, referring to Mr. Morrison's testimony, as follows (R. 62): "Your Honor, it was in anticipation of the Government's argument. . . that I introduced this line of questioning. I have to head it off." This sequence of events leaves no doubt as to (a) counsel's clear understanding of the existence of an "agency" issue, and (b) the fact that he nevertheless saw fit not to introduce testimony of any company official who would have had first-hand knowledge of the events of December, 1967. 8/

Finally, taxpayer seeks to distinguish LaGrange v. Commissioner, 26 T.C. 191 (1956), which held that purported

8/ As part of its "unfair surprise" contention, the Tax Court dissent stated that the Commissioner's "admission" (i.e., the statement that taxpayer "transferred its agreement" to Amsterdam) was only "belatedly retracted" by the Commissioner's "advancing a new theory at a second trial session." (R. 119.) The magnitude of the dissent's error regarding the record is highlighted by the actual chronology of events. For taxpayer's counsel undertook to rebut the agency theory, through the testimony of Mr. Morrison (R. 54) as explained above, prior to the first point in the second trial session (R. 59) at which Government counsel had occasion to articulate the agency theory. Thus, without regard to the matters discussed in the text above, this chronology would indicate that counsel's surprise, if any there was, was lessened by a notable degree of clairvoyance.

sales of forward sale contracts represented in reality an agency relationship. Through his broker (Loeb, Rhoades & Co.), LaGrange entered into two forward sale contracts for British pounds, one with a French bank and the other with Brown Brothers Harriman & Company. After the devaluation of the pound, LaGrange purported to sell the contracts to his broker, which in turn bought pounds from the Chemical Bank for ultimate delivery to the French bank and Brown Brothers. The Tax Court found that LaGrange remained fully liable for delivery until the sales were finally consummated, and on that basis found further that Loeb, Rhoades & Co. had acted not as a buyer but as LaGrange's agent.

Taxpayer contends that LaGrange is distinguishable because, there, the Tax Court found the critical fact to be LaGrange's continued liability. As pointed out by the Tax Court concurrence here, however, in LaGrange the pounds used to close out the forward sales were not, as in this case, purchased from the buyers in the forward sale contracts. In other words, the pound purchases in LaGrange were not truly offsetting contracts, since the forward purchasers (the French bank and Brown Brothers) were not affected thereby until the pounds were actually delivered to them on the contract delivery date in performance of the contract. Thus, LaGrange's continued liability to the forward purchasers was

the factor which demonstrated the agency nature of its relationship with Loeb, Rhoades & Co. In this case, a showing of continued liability is no precondition to a finding of an agency relationship between taxpayer and Amsterdam. The forward purchaser (FNCB) was a party to the transactions of December 20, 1967. At that time, it agreed to procure the pounds which were necessary fully and finally to offset all outstanding obligations to it. No pounds needed to be delivered to FNCB by either of the other parties on the delivery date.

In other words, in this case there was no continuing liability on the part of _either_ taxpayer or Amsterdam after December 20, 1967.[9/] Hence, to determine whether Amsterdam acted on behalf of taxpayer, it is necessary to analyze the events of _that_ day. And when that is done, as explained above, it is clear that Amsterdam did so act. The parties engaged in a pre-arranged series of transactions under which Amsterdam in effect purchased and sold pounds on behalf of taxpayer.[10/]

9/ The Commissioner argued below that the transaction here amounted to a short sale subject to Section 1233 of the Internal Revenue Code of 1954, Appendix, _infra_. That section compels short-term capital gain treatment of any gain resulting from a short sale of a capital asset, where the taxpayer at the time of the sale has held "substantially identical property" for less than six months, or where the taxpayer acquires such property after the short sale and on or before the closing date of the sale. Thus, the statute would be applicable here if taxpayer is treated as having acquired British pounds (through Amsterdam) on January 3, 1968, after having entered into a short sale of pounds (to FNCB) on December 29, 1966.

10/ We might note, however, that FNCB never formally released taxpayer from its obligations. While FNCB's acceptance of the assignment would appear to absolve taxpayer of primary responsibility, there was no release from secondary liability.

A recent Tax Court case, dealing with circumstances similar in many respects to those here, highlights those aspects of the case which indicate that Amsterdam acted here on behalf of taxpayer. In S.C. Johnson & Son, Inc. v. Commissioner, 63 T.C. No. 74 (filed March 31, 1975), the taxpayer executed two forward sale contracts of British pounds which, as in the instant case, became valuable as a result of the 1967 devaluation. After devaluation but prior to the contract delivery date, the taxpayer transferred the contracts to Johnson's Wax Fund, Inc. (Wax Fund), a charitable organization. The Wax Fund in turn sold the contracts to a third party. The principal issue, of no special significance here, was whether the transfer gave rise to a realization of income to the taxpayer. The Tax Court rejected the Commissioner's argument that the taxpayer realized income on the transfer under an assignment of income theory.

In an alternative argument, relevant here, the Commissioner urged that, as a factual matter, the taxpayer had sold the contracts and assigned the proceeds to the Wax Fund. Under this argument, acts of Fund officials would have been imputed to the taxpayer. The argument was rejected by the Tax Court, but on the basis of facts that sharply distinguish Johnson from the instant case. The critical distinctions were that in Johnson (a) all negotiations regarding the subsequent sale of the contracts were instigated solely by the Wax Fund and

(b) this occurred only after the transfer to the Fund had been completed. As the Tax Court stated (S.C. Johnson & Sons., supra, p. 24):

> The record is thus abundantly clear that petitioner's assignment of the two contracts to the Wax Fund had been completed before the ne otiations for the sale of those contracts were undertaken.

Here, by contrast, all but three of the Tax Court judges approved a finding that taxpayer failed to meet its burden of proving that it did not participate in the negotiations that led to the closing out of the forward sale contract. Moreover, it is undisputed that, in thi case, the closing transactions were negotiated, at the latest, simultaneously with the document purporting to transfer the forward sale contract. Accordingly, unlike Johnson, the record here supports the finding that the putative transferee acted on behalf of the taxpayer in its dealings with the forward sale contract.

CONCLUSION

For the reasons stated, the decision of the Tax Court should be affirmed on the basis of the reasoning of the concurring opinion below.

Respectfully submitted,

SCOTT P. CRAMTPON,
Assistant Attorney General,

GILBERT E. ANDREWS,
MICHAEL L. PAUP,
ROBERT A. BERNSTEIN,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

MAY, 1975

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 23d day of May, 1975, in an envelope, with postage prepaid, properly addressed to him as follows:

George Rowe, Jr., Esquire
Michael J. Gaynor, Esquire
Fulton, Walter & Duncombe
30 Rockefeller Plaza
New York, New York 10020

Gilbert E. Andrews/cas
GILBERT E. ANDREWS,
Attorney.

APPENDIX A

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include --

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by --

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding on year from the date of issue.

SEC. 1233. GAINS AND LOSSES FROM SHORT SALES.

(a) [as amended by Sec. 52(b), Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] Capital Assets. -- For purposes of this subtitle, gain or loss from the short sale of property shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer.

(b) Short-Term Gains and Holding Periods. -- If gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under subsection (a) and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 6 months (determined without regard to the effect, under paragraph (2) of this subsection, of such short sale on the holding period), or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof--

(1) any gain on the closing of such short sale shall be considered as a gain on the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

(2) the holding period of such substantially identical property shall be considered to begin (notwithstanding section 1223, relating to the holding period of property) on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. This paragraph shall apply to such substantially identical property in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short.

For purposes of this subsection, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale.

(c) Certain Options to Sell. -- Subsection (b) shall not include an option to sell property at a fixed price acquired on the same day on which the property identified

as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so identified. If the option is not exercised, the cost of the option shall be added to the basis of the property with which the option is identified. This subsection shall apply to options acquired after the date of enactment of this title.

* * *

(e) Rules for Application of Section --

(1) Subsection (b)(1) or (d) shall not apply to the gain or loss, respectively, on any quantity of property used to close such short sale which is in excess of the quantity of the substantially identical property referred to in the applicable subsection.

(2) For purposes of subsections (b) and (d) --

(A) the term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer;

(B) in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in 1 calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month; and

(C) in the case of a short sale of property by an individual, the term "taxpayer", in the application of this subsection and subsections (b) and (d), shall be read as "taxpayer or his spouse"; but an individual who is legally separated from taxpayer under a decree of divorce or separate maintenance shall not be considered as the spouse of the taxpayer.

(3) Where the taxpayer enters into 2 commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical)

commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, subsections (b) and (d) shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

(4) [as added by Sec. 52(a), Technical Amendments Act of 1958, <u>supra</u>] (A) In the case of a taxpayer who is a dealer in securities (within the meaning of section 1236) --

(i) if, on the date of a short sale of stock, substantially identical property which is a capital asset in the hands of the taxpayer has been held for not more than 6 months, and

(ii) if such short sale is closed more than 20 days after the date on which it was made,

subsection (b)(2) shall apply in respect of the holding period of such substantially identical property.

(B) For purposes of subparagraph (A) --

(i) the last sentence of subsection (b) applies; and

(ii) the term "stock" means any share or certificate of stock in a corporation, any bond or other evidence of indebtedness which is convertible into any such share or certificate, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing.

* * *

(g) [as added by Sec. 52(b), Technical Amendments Act of 1958, <u>supra</u>] <u>Hedging Transactions</u>. -- This section shall not apply in the case of a hedging transaction in commodity futures.

APPENDIX B

12-17-70

X 1st Class

UNITED STATES TAX COURT

INTERNATIONAL FLAVORS & FRAGRANCES INC., Petitioner,	:	7768-70
vs.	:	Docket No.
COMMISSIONER OF INTERNAL REVENUE, Respondent.	:	

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (bearing symbols AP:NY:ER:MMC) dated September 25, 1970, and as the basis for its case alleges as follows:

1. The petitioner is International Flavors & Fragrances Inc., a corporation organized and existing under the laws of the State of New York, with its principal office

at 521 West 57th Street, New York, New York 10019. The return for the period here involved was filed with the District Director of Internal Revenue for the District of Manhattan, New York.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on September 25, 1970.

3. The deficiency as determined by the Commissioner is in income tax for the calendar year 1967 in the amount of $73,715.00, all of which is in dispute.

4. The determination of tax set forth in the said notice of deficiency is based upon the Commissioner's error in treating the petitioner's gain of $387,000.00 from the sale in 1967 of its contract with First National City Bank for future delivery to the said Bank of 1,100,000 British pounds sterling as short-term capital gain or alternatively as ordinary income, rather than as long-term capital gain.

5. The facts upon which the petitioner relies as the basis of this case are as follows:

(a) Petitioner's business consists of creating and manufacturing flavor and fragrance products used by other manufacturers to impart or improve flavor or

fragrance in a variety of consumer products. Overseas operations are conducted by subsidiaries of the petitioner. The petitioner did not at any time pertinent hereto own any pounds sterling or any assets the value of which was materially affected by the exchange rate for pounds sterling, other than its investment in subsidiaries in the sterling area.

(b) On December 29, 1966 the petitioner entered into a contract with First National City Bank, 399 Park Avenue, New York, New York, for the sale to the said Bank of 1,100,000 pounds sterling at $2.7691 per pound, delivery to be made on January 3, 1968.

(c) On December 20, 1967, after devaluation of the pound, the petitioner sold the said contract to Amsterdam Overseas Corporation, 70 Pine Street, New York, New York, for $387,000.00, thereby realizing a gain in the same amount.

WHEREFORE, the petitioner prays that this Court may try the case and determine that there is no deficiency in income tax for the calendar year 1967, and that this Court give such other and further relief as the Court may deem fit and proper herein.

Geo Rowe Jr.

George Rowe, Jr.
Counsel for Petitioner
30 Rockefeller Plaza
New York, New York 10020

FORM 4089 (JANUARY 1966)	U. S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE STATUTORY NOTICE STATEMENT	SYMBOLS [illegible]

International Flavors & Fragrances Inc.
521 West 57th Street
New York, New York 10019

KIND OF TAX

Income

TAXABLE YEAR ENDED	DEFICIENCY
December 31, 1967	$73,715.00

It is held that the purchase by the Amsterdam Overseas Corporation of your contract with the First National City Bank for the sale thereto of British pounds sterling was not a bona fide transaction. Therefore, the gain on your transaction with the First National City Bank is a short-term capital gain. In the alternative, it is held that the sale of the pounds sterling was a hedging transaction, the gain whereon is taxable as ordinary income.

☐ Copy to Authorized Representative:

Mr. George A. Weiss
Fulton, Walter & Duncombe
30 Rockefeller Plaza
New York, New York 10020